

**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER: 00-0202**  
**Sales and Use Tax**  
**For The Period: 1996-1998**

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**ISSUES**

**I. Sales/Use Tax: Labels**

**Authority:** IC 6-2.5-5-9(d); IC 6-2.5-5-6; 45 IAC 2.2-5-14; 45 IAC 2.2-5-8(d)

The taxpayer protests the taxation of labels.

**II. Sales/Use Tax: Pricing Equipment**

**Authority:** IC 6-2.5-5-6; 45 IAC 2.2-5-14

The taxpayer protests the taxation of pricing equipment.

**III. Tax Administration: Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-2

The taxpayer protests the imposition of a negligence penalty.

**STATEMENT OF FACTS**

The taxpayer is a wholesaler in the film photo processing business. The taxpayer develops film that was dropped off by customers at various retail stores (e.g., drug stores). After the film is processed, it is sent back to the retail store. The taxpayer has development centers around the country where film is processed.

**I. Sales/Use Tax: Labels**

### **DISCUSSION**

As noted, the taxpayer is in the photofinishing business. The portion of the taxpayer's business at issue involves the following: (1) customers drop off film at a retail store (that is, customers drop off their film rolls at a store and fill out an envelope (wherein the film is placed)); (2) the store in turn forwards the film for processing to the taxpayer; (3) the taxpayer receives the store's "dealer bag" (the individual film is still in its envelope); (4) the taxpayer splices the film with other film rolls and bar codes the film for identification; (5) the taxpayer then begins the film development process; (6) the film print and negatives are placed in a wallet and put back in the envelope—labels are placed on the envelopes "to communicate information to the consumer"; (7) the prints and negative are sent back to the retail store.

The taxpayer argues that the labels are packaging material and are tax exempt under the Indiana Code. The relevant statute is IC 6-2.5-5-9(d), which governs wrapping materials, and states:

(d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

IC 6-2.5-5-6 and 45 IAC 2.2-5-14 are also of import, since both require tangible personal property to be incorporated into the final product in order to be exempt. The former statute stating that "incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business" is required for exemption, and the latter regulation stating in pertinent part "material must be physically incorporated into and become a component of the finished product." Additionally, 45 IAC 2.2-5-8(d) notes that the production process is an integrated series of steps that "ends at the point that the production has altered the item to its completed form, *including packaging*, if required." (*Emphasis added*) The issue then is whether the labels become a material part of the finished product.

The taxpayer's envelopes are not part of the production process and are not part of the finished product. In terms of chronology (pre-production, production, post-production), the envelopes are *pre-production* (i.e., the customer puts the roll of film into an envelope at a retail store, long before the actual production process starts—the production being the taxpayer's business of developing film), and then at the end of production (post-production) the envelopes are used to ship the finished products back to the retail store. The envelopes (and the labels affixed to the envelopes) are not incorporated into, nor are they a component, of the prints. Thus the labels are not part of production, and are therefore taxable.

### **FINDING**

Taxpayer's protest is denied.

## **II.      Sales/Use Tax:      Pricing Equipment**

The taxpayer also protests the taxation of pricing equipment. The taxpayer argues that the pricing equipment is part and parcel of its production process:

Pricing occurs before the sorting process, which is where photographs are sorted and inserted into the appropriate dealer envelope. ... Since pricing occurs before sorting, we feel that pricing should be considered an integral part of an integrated manufacturing process.

Taxpayer describes the pricing machinery as scanning/reading bar codes and then printing the appropriate price to be affixed to the envelope.

Since, under IC 6-2.5-5-6 and 45 IAC 2.2-5-14, the price does not become incorporated as a material part of the taxpayer's product, the taxpayer is not entitled to the exemption. The pricing station does not perform any packaging functions that are exempt in the direct production process.

### **FINDING**

The taxpayer's protest is denied.

## **III.      Tax Administration:      Penalty**

### **DISCUSSION**

The Department imposed a 10% negligence penalty (IC 6-8.1-10-2.1), which the taxpayer argues should be abated. The taxpayer states that the "underpayment of tax was due to [a] clerical error in the normal course of business." The taxpayer also argues that given the size of its organization "a certain amount of error can be expected."

The statutory authority for the penalty is IC 6-8.1-10-2.1, which provides, in pertinent part, that:

If a person subject to the penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to *reasonable cause* and not due to willful neglect, the department shall waive the penalty. (*Emphasis added*)

Beyond the above statements of clerical error and organizational size, the taxpayer did not elaborate on how the failure to properly accrue use tax was due to reasonable cause. 45 IAC 15-11-2(c) requires for abatement for "reasonable cause" that the taxpayer demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty. . . ." The taxpayer has failed to meet its burden of

demonstrating that the underpayments were due to reasonable cause and not due to negligence.

**FINDING**

Taxpayer's protest is denied.

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